

IFRS: What you need to know

# Implications of IFRS Conversion on US Tax Accounting Methods



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A “fresh start” conversion from Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS) allows companies a one-time opportunity to comprehensively reassess the accounting methods used for financial reporting purposes. Tax departments should assess the impact of possible changes in book methods by reviewing the US tax accounting methods of domestic entities with respect to the computation of taxable income and foreign entities with respect to the computation of earnings and profits (E&P).

This comprehensive analysis of US tax accounting methods also provides tax departments a unique opportunity to identify optimal tax accounting methods that meet their tax planning objectives. As part of a US tax methods review, companies should consider whether to continue to follow the GAAP method for tax if the present book accounting method is permissible for tax, to change to the new IFRS accounting method if that method is a permissible method for tax, or to change to some other acceptable tax accounting method that is preferable in light of their tax strategy.

As a change in book and tax accounting methods resulting from an IFRS conversion could have a direct impact on a company's income tax reporting and cash taxes payable, careful consideration should be given to the implications of the company's accounting method choices on required method changes, cash taxes and tax compliance.

## Potential Tax Accounting Method Change Implications

Some commentators suggest that hundreds of book accounting method changes may result from a company's conversion to IFRS. Most of these book changes, however, are not expected to result in tax accounting method changes. Rather, due to the many specific requirements in the tax law that must be followed in determining tax accounting methods, it is our belief that changing book accounting methods primarily will change the computation of, or possibly even eliminate, book-tax differences.

On the other hand, certain tax accounting method changes may be required or desired following an IFRS conversion. Specifically, we expect tax accounting method changes likely will be required or desired primarily under the following circumstances:

- The current tax accounting method requires book-tax conformity and IFRS does not permit the use of the current GAAP accounting method (e.g., the Last In, First Out (LIFO) inventory method);
- Costs are recharacterized as inventoriable for books, resulting in a change in the characterization of costs between sections 471 and 263A;
- A review of the book accounting method uncovers circumstances where tax should not have followed the book method, such as with revenue recognition for multiple deliverable contracts and the characterization of leases; and,
- A review of the current tax accounting method identifies more favorable tax accounting method options.

Note: IRS consent must be obtained to change a US tax accounting method for both US companies or foreign corporations whose E&P is considered “significant” for US tax purposes. Consent is obtained by filing Form 3115, Application for Change in Accounting Method, with the IRS national office in accordance with the procedures outlined in either Rev. Proc. 97-27 or Rev. Proc. 2008-52. While some companies may prefer not to seek formal IRS consent to change their methods of accounting, complying with the applicable procedural requirements provides the company with audit protection that prevents IRS exam from raising the issue in an earlier year, a prospective year of change, and a four-year spread of an unfavorable section 481(a) adjustment or a one-year spread of a favorable section 481(a) adjustment.

## Potential Cash Tax Implications

The tax accounting method implications of an IFRS conversion could have a direct impact on a company’s cash taxes. For example, it is expected that cash taxes could be negatively affected as a result of the inability to use the LIFO inventory method, the potential change in business practices related to leasing, and the acceleration of book recognition of advance payments.

### LIFO

The LIFO method is not allowed for tax purposes unless it is used for financial reporting purposes. Unlike GAAP, IFRS does not allow the use of LIFO. Rather, inventory value under IFRS must be determined using a specific identification, First In, First Out (FIFO), or average cost method. As a result, a company that converts to IFRS will have to terminate any LIFO elections for tax unless a legislative or administrative exception is provided to the book conformity requirement. Termination of LIFO generally will result in the recapture of the tax LIFO reserve over four taxable years, though longer spread periods have been proposed.

### Leasing

Under GAAP, the character of a transaction as either a sale or a lease generally is determined based on form-driven, mechanical rules; by contrast, the tax law requires a substance-over-form analysis of which party has the benefits and burdens of ownership of the property. These

differences between GAAP and tax law could allow companies to achieve favorable results for both book and tax, whereby the transaction is treated as a sale or financing transaction for books under which gain is recognized and as a lease for tax under which no gain is recognized and depreciation is claimed. For example, the requirement that a transaction be treated as a sale under GAAP if the minimum lease payments equate to 90% or more of the value of the leased property could create a book-tax difference if in substance the tax law characterizes this transaction as a true lease based on all the facts and circumstances including whether the leased property has residual value.

Similar to the tax law, IFRS also requires a substance-over-form analysis of which party has the risks and rewards of ownership; however, under IFRS certain factors individually may determine the characterization of a purported lease whereas under the tax law no single factor is dispositive. For example, under IFRS, a transaction must be treated as a sale if the minimum lease payments amount to substantially all of the value of the leased property. In practice, “substantially all” could be interpreted as 90% or more of the value of the leased property making the IFRS determination identical to GAAP. Nonetheless, because both the tax law and IFRS theoretically require a substance over form analysis, the possibility that the book-tax difference related to the characterization of leasing transactions could be eliminated upon conversion to IFRS should be considered. To the extent the IFRS and tax characterization are the same, if a company desires to recognize gain for books, it could be required to structure the transaction as a sale or financing transaction and recognize gain for tax purposes as well.

### Advance Payments

Conversion to IFRS also may accelerate the recognition of advance payments that currently are deferred for tax purposes under administrative exceptions where tax deferral is allowed only to the extent of book deferral.

Specifically, the difference in the treatment of multiple element deliverable arrangements could result in an acceleration of revenue recognition under IFRS, resulting in a similar acceleration for tax purposes to the extent there are advance payments. Under GAAP, a contract

that contains multiple deliverables must be treated as a single unit of accounting unless the company establishes vendor specific objective evidence (VSOE) of the value of each deliverable. As a single unit of accounting, revenue associated with early deliverables may be deferred and recognized with later deliverables. Under IFRS, on the other hand, a company does not need VSOE to establish value and thus revenue typically is recognized as each element is delivered. As a result, it is likely that revenue associated with multiple deliverable arrangements will be accelerated for financial accounting purposes upon conversion to IFRS. The tax rules follow the IFRS rules with respect to when revenue from a multiple element deliverable arrangement is earned; thus, as a general rule conversion to IFRS will not accelerate revenue for tax. However, if the arrangement provides for advance payments, tax deferral is allowed to the extent of book deferral and thus an acceleration of book revenue under IFRS will result in acceleration of tax revenue. For example, because of the lack of VSOE for each deliverable, advance payments associated with software license agreements typically are recognized earlier under IFRS than under GAAP. Upon conversion to IFRS, the recognition of such advance payments will be accelerated for tax purposes as well.

As another example, GAAP generally does not allow the recognition of upfront fees (i.e., advance payments) as income upon receipt. However, IFRS generally will require the recognition of these fees if there is no further performance obligations associated with the separately identified deliverable. Under this circumstance, acceleration of the recognition of these advance payments under IFRS likely will impact the tax recognition to the extent the payments have been deferred for tax.

### Potential Tax Compliance Method Implications

As previously noted, it is anticipated that conversion to IFRS most often will impact the computation of book-tax differences. Several of these book-tax difference computations could be increasingly complex, or even impossible, without significant system changes following an IFRS conversion.

### Service Revenue

GAAP does not allow service revenue to be recognized using the percentage of completion method (PCM), unless the services are included in the scope of SOP 81-1 (generally construction-related services). Somewhat similarly, tax law does not allow use of PCM to recognize service revenue, unless the services are incident to or necessary for the performance of a long-term contract. Instead, revenue must be recognized for tax purposes when due, paid, or earned because the required services (or divisible services) are complete.

IFRS, on the other hand, requires the use of PCM in recognizing revenues under service arrangements. The required use of PCM under IFRS is expected to result in book-tax differences that will be very difficult to compute. Theoretically, it could be necessary to analyze hundreds or thousands of service arrangements to determine when the required services are complete, and thus, when revenue should be recognized for tax purposes.

### Component Depreciation

GAAP allows, but IFRS requires, use of component depreciation, under which an asset is broken down into its significant components for purposes of determining depreciation, disposals, and repairs. Thus, under IFRS, an airplane likely would be treated as several different assets, including the airframe, each engine, and wheels and brakes. The tax law, on the other hand, defines the relevant unit of property more broadly, generally examining whether a component is functionally interdependent with another component. In fact, the court in *FedEx Corporation v. United States* (291 F.Supp.2d 699) determined that an airplane and all its functionally interrelated parts, including the engine, constitute a single unit of property for tax purposes.

As a result, it is likely that the unit of property used for financial reporting purposes under IFRS will differ substantially from the unit of property used for tax purposes. Tracking fixed asset additions and disposals, as well as analyzing repairs to identify capital improvements based on different units of property, is expected to be extremely complex and administratively burdensome.

## **Requesting Relief**

Taxpayers and practitioners may want to consider providing comments to legislative or regulatory authorities prior to the mandatory adoption of IFRS to request relief for these and other tax compliance issues that are expected to arise. For example, taxpayers might want to suggest that the IRS provide a safe harbor that allows service revenue to be recognized using a billing method or consistent with IFRS recognition, particularly considering IFRS will accelerate recognition of service revenue relative to tax law.

## **Next Steps**

Companies assessing the impact of IFRS on their organization need to keep the tax accounting method implications in mind. While we have focused on impacts in the US, a similar analysis will be necessary for each jurisdiction in which a company operates, taking into consideration all of the country specific requirements for changes. Involving the tax department in the assessment of accounting policy options is essential to gaining a complete picture of the potential benefits and drawbacks of the accounting changes that will result from conversion to IFRS. A complete analysis of a company's current tax accounting methods and consideration of the tax variables resulting from the IFRS conversion can help the company identify opportunities to mitigate potential tax accounting method issues and manage cash taxes.

# Contacts

The white paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of IFRS:

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PricewaterhouseCoopers is committed to helping companies navigate the conversion from GAAP to IFRS. With that in mind, please visit **[www.pwc.com/usifrs](http://www.pwc.com/usifrs)** to view a complete list of our comprehensive IFRS thought leadership, webcasts and additional tools addressing the business and technical issues that companies should be considering in anticipation of the inevitable move from GAAP to IFRS.

